DEPARTMENT OF THE
TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

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MEMORANDUM FOR PAULINE RIENDEAU. NATIONAl DIRECTOR OFFICE OF INTEREST AND PENALTY ADMINISTRATION

FROM: Lewis J. Fernandez, Deputy Assistant Chief Counsel (Income Tax & Accounting)
CC:DOM:IT&A

SUBJECT: Return Preparer Penalty Assessments for EIC Due Diligence and Understatement on Preparers Who Are Employers

This is In response to your written request for information dated March 22, 2000, which aaked for our adVice regarding the assessment of the 6695(g) preparer due diligence penalty and the 6694(a) and (b) preparer undestatement penalties in situations involving an employer/preparer and an employee/preparer.

ISSUES

1. Whether the 6695(g) penalty for failure to satisfy the EIC due diligence requlrement may be imposed on an employer/preparer, an employee/preparer, or both an employer/preparer and an employee/preparer.

2. Whether the 6694(a) or (b) penalty for understatement of taxpayer liability by an income tax return preparer may be imposed on the employer/preparer, an employee/preparer or both an employer/prepare and an employee/preparer.

CONCLUSIONS

Under a strict application of the Internal Revenue Code and Income Tax Regulations, the §6695(g) penalty can be assessed against either an employee/preparer or an employer/preparer, or both. [redacted]

[redacted]

2. Under certain circumstances, the 6694(a) and (b) penalties can be assessed against both an employee/preparer and an employer/preparer. In order to assess against both, the preconditions under § 6694-2(a)(2) and § 1.669-3(a)(2) of the Income Tax Regulations must be met before the penalties can be assessed against the employer in addition to the employee. Further, an assessment against both an employee/preparer and an emplover/preparer is limited by the one-preparer per firm rule, found in § 1.6694-1 of the regulations.

FACTS

Under your facts, an owner of a firm that does tax return preparatlon has five emptoyees. One employee completes aII the retums having an earned income credit (EIC). A Service field visit establishes a failure to comply with the due diligence requirements if § 6695(g) of the Internal Revenue Code on all of the EIC retums.

DISCUSSION

Issue One:

Section 6695(g) of the Code provides:

> ... an income tax retum preparer with respect to any retum or claim for refund who falls to comply with due diligence requirements imposed by the Sectretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by § 32 shall pay a penalty of S100 for each such failure.

Income tax retum preparer is defined under § 7701(a)(36) of the Code as any person who prepares for compensation, or who employs one or more persons to prepare for compensation any return of tax Imposed by subtitle A or any claim for refund of tax Imposed by subtitle A. A person is defined under § 7701(a)(1) of the Code as “an individual, a trust, estate, partnership, association, company or corporation.

Setion 301.7701-15(a)(1) of the regulations provides that a compensated person is a preparer when such person ”. . . fumishes to a taxpayer or other preparer sufficient information and advice so that completIon of the return or claim for refund Is largely a mechanical or clerical matter.” As a corollary, persons who provide only typing, reproduetion, or other mechanical assistance in the preparatjon of a retum or claim for refund are not considered preparers. Section 301.7701-15(d)(1) of the regulations.

Although mere mechanical assistance does not render a compensated person an income tax preparer, a person who provides more than mechanical assistance does not avoid income prepare requirements by lack of education or professional status. Section 301.7701-15(a)(3) of the regulations. The Code and regulations contemplate that there can be more than one tax retum preparer for a given return, and the provision of computerized tax preparation services, when rendered through the use of standardized forms provided by another preparer, renders a firm a retum preparer under the Code. Rev. RuI. 85-187, 1985-2 C.B. 338.

We can infer from your facts that the firm received compensation for the EIC returns in question. By definition. the employee/preparer received compensation from the firm. We can also infer from your facts that the employee/preparer furnished to the taxpayers in question the kind of advice that is contemplated by § 301.7701-15(a)(1) of the regulations. Accordingly, under your facts, both the firm (In this case a sole proprietorship) and the emplovee are income tax return preparers for purposes of § 7701(a)(38) of the Code.

Section 6107(a) of the Code requires an Income tax return preparer to furnish a copy of the retum to the taxpayer. Sectlon 6107(b) of the Code requires an income tax return preparer to retain a copv of returns prepared for taxpayers, or, in the alternative, majntaln a list of the names and taxpayer identification numbers of taxpayers when returns were prepared. However, when an employment relationship exists among two preparers for a given retum, the responsibillty for the § 6107(a) and (b) requirements falls on the employer/preparer. See Section 1.6107-1(c)(1) of the regulations; see also Rev. Rul 85-187, 1985-2 C.B. 338.

An employment relationship aIso places the burden to satisfy other requirements under the Code on the employer/preparer. See Section 1.6060-1 (employee/preparers do not fall within requirements for employee record retention): Section 1.6695-1(c)(2) (penalty for failure to provide identifying number not applied to employee); but cf. § 1.6695-1 (b)(2) (as between multiple preparers, the individual preparer who has the primary responsability as between or among the preparers for the overall substantive accuracy of the retum must sign the return as preparer).

Section 1.6695-2T of the Temporary Regulations establishes the EIC due dillgence requirements that preparers must satisfy. This section does not distinguish between employee/preparers and employer/preparers in the application of its requirements. Thus, there is no legal prohibition against assessing the § 6695(g) penalty against either or both the employee/preparer and the employer/preparer. [redacted]

[redacted]

For example, in considering 1.6695-2T(b)(4) of the regulations, which imposes special record retention requirements for EIC retums, we would observe that, while this section nominally places specialized record retention requirements upon all preparers, employee/preparers included, § 1.6107-1(c) of the regulations places the generalized record retention requirements with respect to all retums exIusivly on employer/preparers. Given that the Service has historically applied the overwhelmIng bulk of record retention requirements exclusively to employer/preparers through § 6107-1(c), it would be inconsistent for the Service to now require employee/preparers to meet the specialized record retention requirements of §1.6695-2T(b)(4).

When coneldared as a whole, the other due diligence requirements Imposed by § 1.6695-2T are closely similar to the mechanical, ministerial-type requirements of §§ 6060, 6107 and 6695(c) of the Code: these include completion of the eligibility checklist or altemate form (§1.6695-2T(b)(2) and computing the credit by use of the Earned Income Credit Worksheet (§1.8695--2T(b)(2). All of these requirements are easily identifiable mechanical tasks, which is why the failure to perform them is penalized under § 6695 of the Code rather than § 6694. [redacted]

A remaining matter to consider is whether the Service can assess the 6695(g) penalty against both the employee/preparer and employer/preparer on the same return. The regulations are silent on this point. The Service has decided that under certain circumstances the § S694 penalty can be assessed against both an employee/preparer and an employer/preparer. However, the Service adopted this position only after notice and comment that culminated in the promulgation of §§ 1.6694-2(1)(2) and 1.6694-3(a)(2) of the regulations (discussed below). [redacted]

Issue Two:

The application of § 6694(a) and (b) penalties differs from the application of the § 6695(g) penalty in that § 6694 imposes a penalty for taking a position on a return, not for failures to complete certain forms and retain records. In contrast, the § 6695 penaIties involve the consideration of whether certain mechanlcal tasks have or have not been undertaken. Addltionally, the Service has issued regulations which specifically cover the appficatlon of the § 6694(a) and (b) penalties in the context of the employer/employee relationship.

Sections 1.8814-2(1)(2) and 1.6694-3(a)(2) of the regulations establish heightened requlrements in order for an employer to be subject to the § 6694-T4 penalties in addition to an employee who Is subject to the penalty. These requirements eatablished by § 1.6694-2(.)(2) (for the unrealistic position penalty) and § 1.6694-3(a)(2) (for the wlllful, reckless, or Intentional conduct penalty) basically amount to supervisory complicity in the understatement at issue. Section 1.6694-2(a)(2) states as follows (the corresponding language of § 1.6694-3(a)(2) is virtually Identical):

> *Special* rule *for employers* and *partnerships.* An employer or partnership of a preparer subject to penafty under § 6694(a) is also subject to penalty only if-
>
> > (i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by § 6694(a);
> >
> > (ii) The employer or partnership failed to provide reasonable and appropriate procedures for review of the position for which the penalty is Imposed; or
> >
> > (Ill) Such review procedures were disregarded in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty was Imposed.

The § 6694(a) or (b) penalty cannot apply to an employer unless the higher burdens in the regulations are met.

We would also note that, when the employer Is a firm, the “one-preparer-per-firm rule,” found in § 1.6694-1, will limit the assessment of the § 6694 penalty to only the employee/preparer and the firm as an entity. However, if the employer/preparer operates as a sole proprietor, no such limitation will apply and

both the employee/preparer and the employer/proprietor, in an individual capacity, can be assessed. Section 1.6694-1(b)(1) of the regulations.

There are not enough facts provided in your hypothetical situation in order to determine whether the employer/preparer has done anything that would warrant assessment under 1.6694-2(a)(2) and 1.6694-3(a)(2). Accordingly, we can conclude only that it would be permissable to assess the employee/preparer in this situation and express no opinion regarding the employer/preparer.

If you have questions regarding this memorandum, please contact Brinton T. Warren at (202) 622-8477.